

Part III - Administrative, Procedural, and Miscellaneous

State and Local General Sales Tax Deduction

Notice 2005-31

This notice provides guidance to taxpayers regarding the election to deduct state and local general sales taxes in lieu of state and local income taxes under § 164(b)(5) of the Internal Revenue Code for taxpayers who elect to itemize deductions under § 63(e). Section 164(b)(5) was added by § 501 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, and applies for taxable years beginning after December 31, 2003, and before January 1, 2006.

BACKGROUND

Section 164(a)(3) provides, in part, that taxpayers may deduct state and local income taxes in the taxable year the taxes are paid or incurred. Under § 164(b)(5), taxpayers may elect to deduct state and local general sales taxes in lieu of state and local income taxes.

A general sales tax is a tax imposed at one rate with respect to the retail sale of a broad range of classes of items. Section 164(b)(5)(B). In determining whether the tax is imposed on a broad range of classes of items, the fact that sales taxes do not apply to some or all food, clothing, medical supplies, and motor vehicles is disregarded. Section 164(b)(5)(C)(i). In determining whether the tax is imposed at one rate, the fact that the tax rate that applies to food, clothing, medical supplies, or motor vehicles is lower than the general tax rate is

disregarded. Section 164(b)(5)(C)(ii).

In general, sales taxes that are imposed at a rate other than the general rate of tax are not deductible. However, sales taxes imposed on (1) food, clothing, medical supplies, or motor vehicles at a rate lower than the general rate of tax may be deducted, and (2) motor vehicles at a rate in excess of the general sales tax rate may be deducted only at the general sales tax rate. Section 164(b)(5)(D) and (F).

If the amount of a sales tax is separately stated and paid by the consumer (other than in connection with a trade or business), the amount of the tax is treated as a tax imposed on and paid by the consumer rather than the seller. Therefore, the consumer may deduct sales taxes that are imposed on the seller if the tax is separately stated (as on a contract or receipt) and paid by the consumer. Section 164(b)(5)(G).

A compensating use tax is treated as a sales tax if the tax (1) is imposed on the use, storage, or consumption of an item, and (2) is complementary to a general sales tax that would be deductible with respect to similar items. Section 164(b)(5)(E).

Taxpayers who elect to deduct state and local sales taxes may deduct either actual sales taxes paid or incurred, as evidenced by appropriate records, or an amount determined under tables provided by the Service. For 2004, tables are provided in Publication 600, Optional State Sales Tax Tables. A taxpayer who elects to use the optional sales tax tables may deduct (1) the amount determined under the tables, as provided in the instructions, plus (2) the actual

amount of state and local general sales taxes paid on motor vehicles, boats, and certain other specified items. Section 164(b)(5)(H).

APPLICATION

Manner of making election to deduct sales taxes

Taxpayers elect to deduct state and local general sales taxes in lieu of state and local income taxes on Form 1040, Schedule A, in accordance with the instructions. A taxpayer may elect to deduct state and local general sales taxes in one taxable year and state and local income taxes in another taxable year.

The election for a taxable year for which the period of limitation for filing a claim for refund or credit under § 6511 has not expired may be revoked by filing an amended return for that taxable year.

Definition of motor vehicle

For purposes of deducting state and local general sales taxes, a “motor vehicle” includes an automobile, motorcycle, motor home, recreational vehicle, sport utility vehicle, off-road vehicle, van, or truck (any of which may be either purchased or leased). For these items, if sales taxes are imposed at rates that exceed the general sales tax rate, sales tax may be deducted only at the general sales tax rate.

Determination of amount of sales taxes paid by using the optional sales tax tables

The optional sales tax tables provide an amount of sales taxes paid based on a taxpayer’s state of residence, total available income, and number of exemptions.

The state of residence is the state where the taxpayer physically resides. A taxpayer who lives in different states during the taxable year who elects to use the optional sales tax tables must multiply the amount determined under the tables for each state of residence by a fraction, the numerator of which is the number of days physically resident in the state and the denominator of which is the number of days in the year.

Example. Taxpayer S lives in State A from January 1 through August 31, 2004 (244 days), and in State B from September 1 through December 31, 2004 (122 days). The amount of S's deduction for state and local sales taxes determined under the optional sales tax tables would be \$500 if S had lived in State A for the entire year and \$400 if S had lived in State B for the entire year. S's deduction for state and local sales taxes is \$466 calculated as follows:

State A: $\$500 \times 244/366 = \333

State B: $\$400 \times 122/366 = \underline{\$133}$

Total \$466

Total available income is adjusted gross income (AGI) plus amounts not reflected in AGI that increase spendable income, such as worker's compensation, public assistance payments, military compensation earned in a combat zone, tax-exempt interest, the refundable portion of refundable tax credits, and the nontaxable part of social security, veterans' or railroad retirement benefits and of IRA, pension or annuity distributions.

The number of exemptions is the number included on the taxpayer's tax return. See special rule, below, for taxpayers filing a joint return and living in

different states.

Deductions for local general sales taxes under the optional sales tax tables

For 2004, the amounts provided in the optional sales tax tables do not include amounts paid for local general sales taxes. For 2004, taxpayers may add amounts paid for local general sales taxes to the amount determined under the tables. For 2004, the amount of local general sales taxes paid may be determined by multiplying the taxpayer's state table amount by the ratio of the local sales tax rate to the state sales tax rate.

Example. State A imposes a 5.0% general sales tax in 2004. City B in State A imposes an additional 1.0% general sales tax in 2004. Taxpayer C lives in City B. Taxpayer C's deduction for state sales taxes determined under the optional sales tax tables is \$1,000. To calculate the additional amount for the City B local sales tax, divide 1.0 (the local City B tax rate) by 5.0 (the State A tax rate). The result is 0.2. Multiply Taxpayer C's deduction for state sales taxes determined under the optional sales tax tables by 0.2. The additional City B local sales tax is \$200. Taxpayer C's deductible State A and local sales tax is \$1,000 + \$200, or \$1,200 (before adding the tax on any specified items).

For 2005, it is expected that the optional sales tax tables will include local sales taxes if local sales taxes are imposed at a uniform rate throughout the state. It is also expected that for 2005, taxpayers will be allowed to determine the deduction for local sales taxes in the manner discussed above if local sales taxes not included in the optional sales tax tables are imposed on the same items taxed by the state. In states where state sales taxes and local sales taxes are

not imposed on the same items, instructions accompanying the optional sales tax tables for 2005 may provide specific information for determining the amount of local sales taxes from the optional sales tax tables. If none of the preceding options is available to a taxpayer for 2005, the taxpayer may deduct only actual local sales taxes paid or incurred, as evidenced by appropriate records.

Specified items on which sales taxes may be deducted by taxpayers using the optional sales tax tables

In addition to the amount determined under the optional sales tax tables and amounts added for local general sales taxes, taxpayers may deduct allowable actual state and local general sales taxes paid on the purchase of the following items: motor vehicles (including automobiles, motorcycles, motor homes, recreational vehicles, sport utility vehicles, off-road vehicles, vans, and trucks), boats, aircraft, homes (including mobile and prefabricated homes), and materials to build a home.

Use of the optional sales tax tables by taxpayers filing a joint tax return and living in different states

Taxpayers who file a joint return, live in different states, and use the optional sales tax tables must calculate the amount of the deduction for state and local sales taxes by applying their separate incomes to the table for each state of residence, taking into account the exemptions for dependents who resided with each taxpayer, and adding the total. Either spouse (but not both) may take into account dependents who did not reside with either taxpayer.

Deduction of state and local sales taxes by taxpayers filing tax returns as married

filing separately

A married taxpayer filing a separate tax return who elects to deduct state and local sales taxes must use the optional sales tax tables if the taxpayer's spouse elects to deduct sales taxes and uses the optional sales tax tables.

In using the optional sales tax tables, a married taxpayer filing a separate return must apply the taxpayer's separate income and the number of exemptions included on the taxpayer's return.

Example. Taxpayers W and H are married, have three children, and file their tax returns as married filing separately. W's total available income is \$40,000, and W includes exemptions for herself and one child on her tax return. H's total available income is \$60,000, and H includes exemptions for himself and two children on his tax return. W determines the amount of her deduction for state and local sales taxes under the optional sales tax tables based on \$40,000 income and two exemptions. Thus, H must determine the amount of his deduction for state and local sales taxes under the optional sales tax tables based on \$60,000 income and three exemptions.

DRAFTING INFORMATION

The principal author of this notice is David M. Christensen of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Mr. Christensen on (202) 622-7900 (not a toll free call).